EUR: Draghi downside

A dovish ECB should keep the euro under pressure

Source: Andrej Klizan

USD: Outperforming the collapse in US rates

The recent bullish re-steepening of the US 2-10 year curve suggests investors firmly believe that the Fed will cave in and cut rates. Two-year US swap rates are already trading at a deep, 50 basis point, discount to Fed Funds, but may not fall much further until the Fed signals imminent easing or major activity data (e.g. tomorrow's nonfarm payrolls report) signals sharp deterioration. The dollar would be lower, were it not for: (i) the nature of the current shock (trade) and (ii) unattractive Europe.

EUR: Projections and TLTRO III in focus

The highlight of today's session will be the European Central Bank meeting and press conference. As Carsten Brzeski writes, the ECB meets at a time of sinking inflation expectations and much uncertainty around trade. ECB GDP growth forecasts made in March may not be revised too much (1.1%, 1.6%, 1.5% for 2019, 20 & 21, respectively), while any downward revision to the CPI forecasts (1.2%, 1.5% & 1.6%) would weigh further on already soft euro market interest rates. In focus will be the terms of the Targeted Longer-Term Refinancing Operations (TLTRO) III starting in September. Any suggestion of a variable rate, (rather than a single rate over potentially four operations) would also add to speculation that TLTROs (rather than depo rate cuts) may play a greater role in ECB monetary policy going forward. A dovish ECB should keep the EUR under pressure on the crosses and EUR/USD resistance at 1.1310/25 intact. Any upside breakout would likely come tomorrow – were the US jobs report to come in shockingly poor and tip the Fed over the edge into an insurance rate cut.

GBP: Peterborough by-election to weigh

Politics will be back in focus today with the Peterborough by-election. Long a Conservative seat, this was lost to Labour in the 2017 election and today could present the Brexit party with its first MP. The scale of any Brexit party win stands to drag the Conservatives further to the right and increase the chance of a No Deal Brexit. 1.2750/2800 should remain the top of cable's range.

MXN: Bracing for more bad news

The Mexican peso is slipping in the rankings as one of the top emerging market FX performers this year, hit most recently by the threat of escalating US tariffs in response to illegal immigration. It's not clear Mexican officials (still in Washington) can do enough to prevent tariffs going into effect next Monday – though we suspect this issue and perhaps ratification of the USMCA is resolved by the end of August. MXN has also been hit by a downgrade to BBB from Fitch – which occurred earlier than we thought. Still a BBB rating should not hit MXN too hard, since it now matches the sovereign rating of the Indonesian rupiah and remains superior to the other high yielders of the Brazilian real (BB-), rouble (BBB-) and South African rand (BB+). We see a risk of USD/MXN moving to the 20.25/50 area if tariffs go into effect next Monday, but see it returning to the 19.00/19.50 area once relations improve with the US later this year.

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